Goldman Sachs
Asset Management

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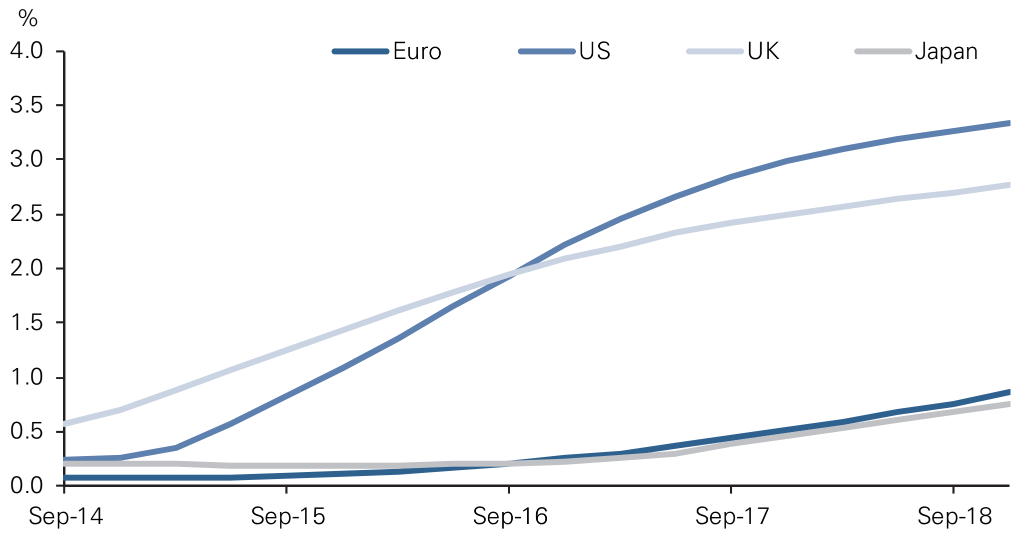
GSAM | Macro Insights

Divergent Paths, Divergent Opportunities

- Economic data suggest increased divergence in growth trends as the US continues to expand while the Eurozone, Japan and some emerging economies struggle with weak growth (p. 2).
- Diverging growth trends are leading the US Federal Reserve and the European Central Bank (ECB) in opposite directions (p. 6)...
- ...and increasing the likelihood of higher market volatility and more regional differentiation by investors (p. 3).
- In our *Focus Piece*, GSAM's Alternative Investments & Manager Selection Group examines how divergence and other themes are driving strategy in the hedge fund and private equity universe (p. 4).

Policy Paths Diverge

3-Month Interbank Rate Forward Curve

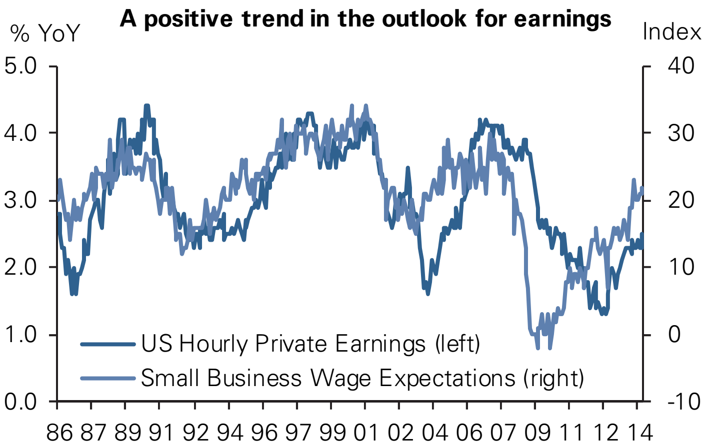


Source: Bloomberg, GSAM.

Macro Trends and Views

US

- US non-farm payrolls added 142,000 jobs in August, significantly disappointing consensus expectations of 230,000.
- Other economic growth indicators pointed to continued positive momentum, with the Manufacturing PMI reaching a three-year high of 59.0, along with positive wage growth and auto sales data.
- In light of the overall strength in US growth data we believe the Fed is likely to increasingly emphasize data dependency with respect to policy tightening.



Source: Bloomberg

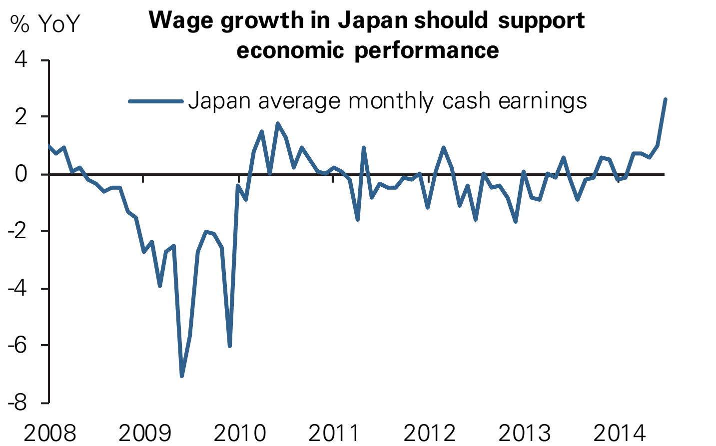
Europe

- The European Central Bank cut rates to record lows at its Sept. 4 meeting, and announced plans to begin purchasing asset-backed securities and covered bonds.
- ECB President Mario Draghi cited weak economic growth and low inflation expectations as drivers of the further easing measures.
- In August, the Eurozone Manufacturing PMI hit a 13-month low of 50.7 and headline inflation fell to 0.3% from 0.4% in July, primarily on lower food and energy prices.

Source: Bloomberg

Japan

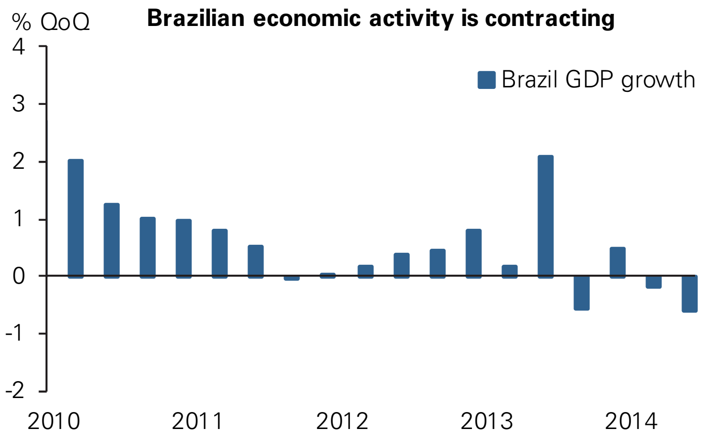
- Japan's GDP contracted 7.1% annualized in 2Q 2014, revised down from a preliminary estimate of 6.8%, which was the largest contraction since 1Q 2009.
- Core consumer prices rose 3.3% in July from a year earlier. Much of the rise is due to the 2% increase in Japan's sales tax in April.
- Wage growth picked up significantly, rising 2.6% in July, beating forecasts of 0.9%. Sustained wage growth will be key to stimulating economic activity in the face of rising consumer prices.



Source: Bloomberg

Growth Markets

- Brazilian GDP dropped 0.6% in the second quarter, largely driven by decreased consumer spending, and first quarter GDP results were revised to –0.02% from 0.02%.
- In Russia, the ruble declined 3.8% against the dollar in August and core inflation continued to trend higher, to 7.6%, with the probability of further sanctions to be imposed by the US and EU.
- Oil prices continue to weaken despite ongoing geopolitical tensions in Ukraine and the Middle East. The decline in prices is largely due to increases in Libyan supply and slower growth in China.



Source: Bloomberg

Market Trends and Asset Allocation Views

For the last five months, we have witnessed very low macroeconomic volatility where, despite improvements in economic fundamentals and rising equity markets, central banks maintain low interest rates globally. Next, we expect to move into an environment of higher volatility and greater regional differentiation. These differences include investors' expectations for growth, inflation and policy makers' reaction functions. The latter is exacerbated by a wider range of available tools for central bankers. Strategic diversification combined with nimbleness should help investors respond to subsequent asset price movements.

Our overall macro calls this year have continued to play out, namely growth acceleration and middling inflation leading to reasonable DM equity returns, stability in credit markets and a shift in US policy. Data continues to improve in the US and we see catalysts such as housing coming forward to contribute to a higher growth rate than other developed market economies.

Transitioning China's $2 trillion economy will naturally be hard to co-ordinate. Our base case is not for a hard landing, as growth continues to be underwritten by policy and we expect the latest announcement of People's Bank of China easing to have a positive impact. The delay of some infrastructure spending from the first half of the year to the second should provide a tailwind for growth. Having said that, we remain alert for opportunities to hedge any micro-cycles in credit, stimulus and confidence.

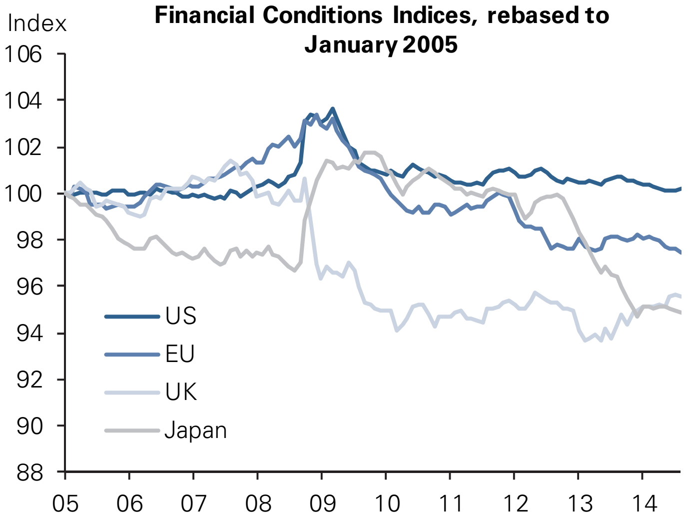
In Europe, growth remains fragile and the recovery could be volatile. By contrast, UK output has rapidly accelerated. The cooling of this, plus political uncertainty introduced by the Scottish referendum and looking ahead to the general election next year could make the region more vulnerable to growth disappointments. In Japan, we think recent growth disappointments go beyond the effect of the consumption tax and expect further easing by the Bank of Japan (BoJ) this year.

Alongside this growth backdrop has been a benign inflationary environment. Similar to the bottoming of the volatility cycle, we think inflation in many regions is forming a base. In the US and UK, we are looking for pressures on core inflation to emerge. Tightness in labor markets is manifesting in some surveys, but not a meaningful acceleration in wage growth, and commodity prices are exerting downward pressures. We think the threshold for rising inflation to decisively change the Fed's tone to a hawkish one could be quite high.

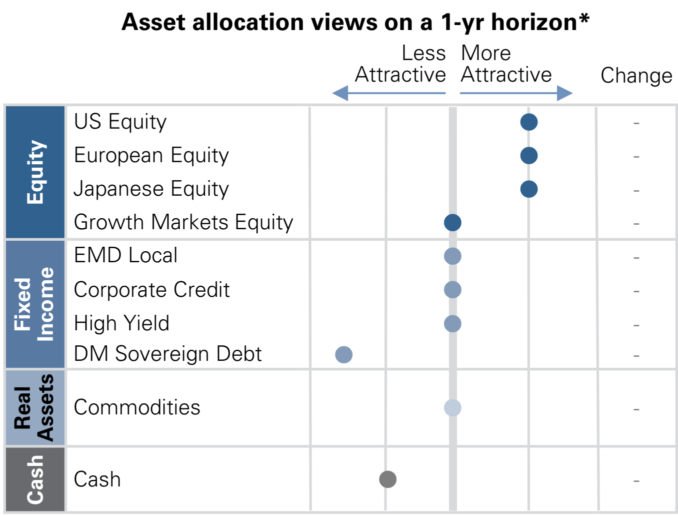
Importantly, we think that we may soon see a turning point in European inflation, with impacts in core and peripheral bond markets over coming quarters. We do though expect sovereign easing in Europe in 2015. This means that even as the Fed and Bank of England (BoE) withdraw stimulus, the ECB and BoJ could continue to provide liquidity.

What does this mean for asset prices going forward? Even at new highs in many developed equity markets, we feel comfortable sticking to our overweights. When adjusted for inflation, valuations are roughly at long term averages. In order to achieve tightening in the face of European and Japanese easing, the Fed may have to accept a stronger dollar, especially relative to those currencies. Despite US economic data, long term interest rates seem to be anchored by European ones and so our underweight to US rates has shifted to shorter-dated yields. Very low Eurozone rates could benefit corporate or Emerging Market bonds and currencies. However, we acknowledge that these assets can be driven by liquidity and risk sentiment rather than economics. We are neutral on physical assets, seeing improving fundamentals in real estate, and hold an overweight to oil as a mitigant for geopolitical pressures.

With divergence and turbulence comes opportunity and we look forward to navigating differences in growth and policy across global asset markets through the end of the year.



Source: Bloomberg



Source: GSAM Global Portfolio Solutions. As of September 2014.
* Note that this does not account for liability-driven investment.

Focus Piece: An Alternative View

In this month's Focus Piece, GSAM's Alternative Investments & Manager Selection Group examines external hedge fund and private equity managers' latest views and positioning in the context of three key macro, fundamental and secular themes.

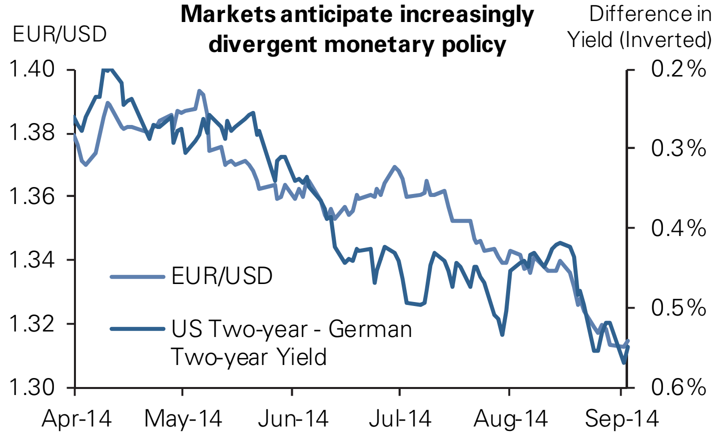
Alternative investment managers view the available opportunity set through a variety of lenses. Opportunities can be sourced from, among other things, a top-down assessment of the macro environment, a bottom-up analysis of changing corporate fundamentals, and a structural evaluation of secular disruption in different industries. Looking ahead to the remainder of 2014 and into next year, below we discuss a sample of three key themes for alternative strategies in each of these buckets:

- Some macro managers believe policymakers are behind the curve relative to divergent growth outlooks, and shifts in policy going forward will create opportunities.
- Fundamental managers are especially focused on US growth and a meaningful pickup in corporate activity.
- Structural changes in the energy market continue to provide a major secular disruption that is generating a range of opportunities for commodity specialists and public and private equity investors.

Divergent Paths, Divergent Opportunities

Viewing the world through a lens of Global Purchasing Manager Indices (PMIs), we can place various economies at different points in the business cycle. From this perspective, the US economy has recently rebounded from a slowdown in Q1, and is currently in an expansion phase, Japan moved from slowdown to expansion in August (despite continued economic weakness more broadly), while Europe is in slowdown. In emerging markets, dispersion in economic outlooks has allowed macro managers to identify and trade around country-specific developments.

Markets anticipate increasingly divergent monetary policy



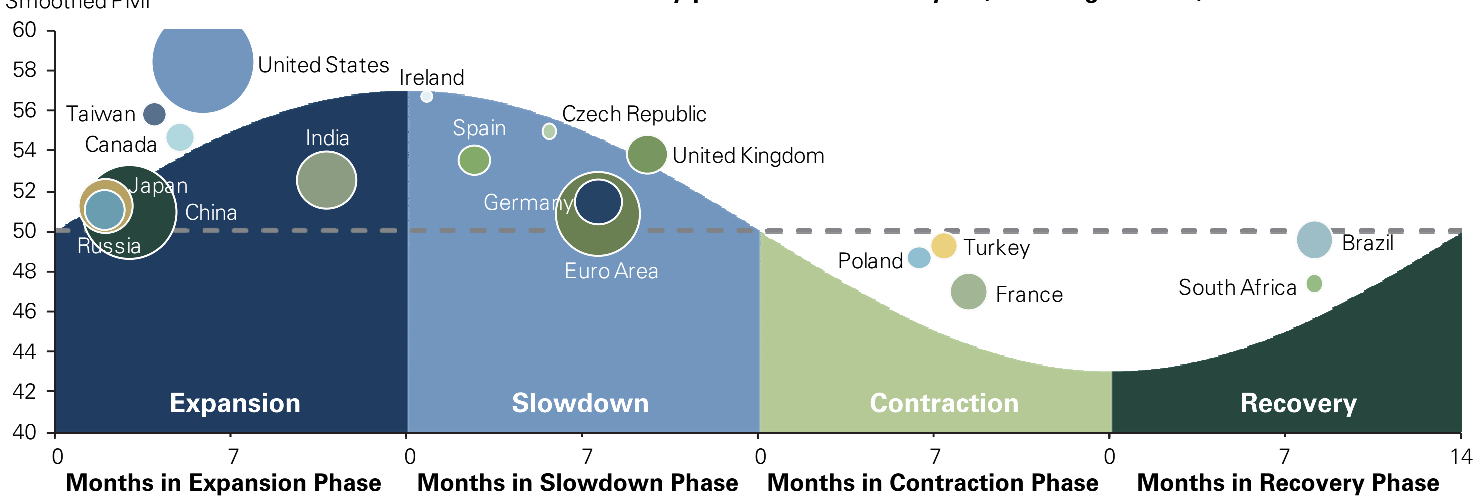
Source: Bloomberg as of September 2014.

Divergent paths for growth and employment have created a dichotomy between expectations of a more neutral or even hawkish stance adopted by the Fed and BoE versus expectations of further extraordinary easing from the ECB and BoJ.

The market is currently pricing in an initial rate hike by the Fed in mid-2015, but many macro managers are positioning for yields to begin moving higher sooner, as investors reprice expectations through the remainder of this year. Managers are positioned for this by being long USD and short US fixed income, particularly toward the front end of the curve. Similarly, managers are watching for further indications of when the BoE will start to raise rates.

In contrast, managers expect European policymakers to continue to move in the opposite direction to offset weak growth and deflationary pressure, and are positioned through long fixed income and short EUR positions. This trade has played out well for managers, particularly after the ECB announced new easing packages in June and September. With the move to negative deposit interest rates and the announcement of outright quantitative easing, some have taken profits on their long fixed income positions

Smoothed Global PMI Values by phase of Economic Cycle (as of August 2014)



The economic phases above are defined by two signals based on the level and momentum of the smoothed PMI data. A smoothed PMI print above 50 with positive (negative) momentum indicates expansion (slowdown). Similarly, a smoothed PMI print below 50 with positive (negative) momentum indicates recover (contraction).

Focus Piece: Cont'd

following the strong rally. Many macro managers are also combining views on both Europe and the US through long European fixed income vs. short US fixed income positions.

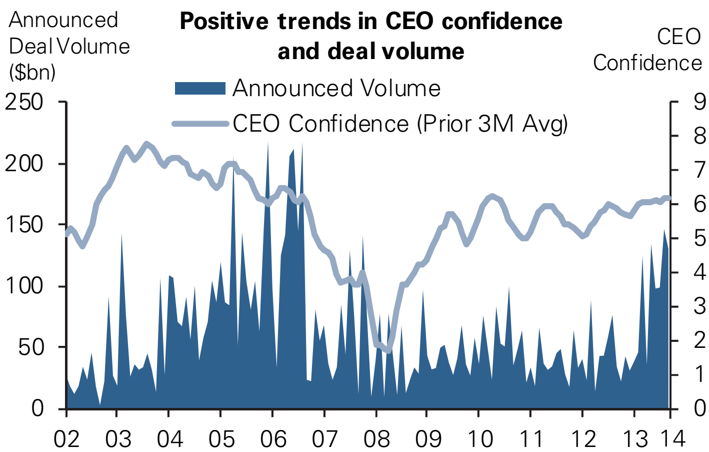
In Japan, while managers continue to tactically trade short Yen positions, some have de-emphasized currency and interest rate positioning in recent months. Instead, they have focused more on long equity positions. Managers believe two factors potentially bode well for Japanese equities in the coming quarters: (i) recent weak GDP data gives credence to the view we may see further action from the BoJ and (ii) the expectation for an increase in the massive Government Pension Investment Fund's allocation to equities.

Profiting from Stronger US Corporate Activity

Amid an improving US economy, M&A activity grew to approximately $797.5bn (Bloomberg) in announced deal volume through Aug. 31—more than the announced volume in all of 2013—driven by a surge of deal activity in the healthcare and communication sectors; however, the number of deals remains well below peak levels as volume has been driven by large, strategic acquisitions. Tight deal spreads in the first half of 2014 kept merger arbitrage levels low, but allocations to merger arbitrage from multi-strategy or event driven managers have increased in recent months as spreads have become more attractive for complex transactions, such as cross border mergers, hostile takeovers and deals facing regulatory scrutiny. While there have been several notable deal breaks in 2014, event driven managers generally have a positive outlook for the merger arbitrage opportunity set going forward.

Heightened M&A activity is one factor that has driven valuations, creating a favorable environment for private equity exits but presenting challenges in finding attractively valued new deals. As a result, private equity managers are being more cautious in their deal-making despite the availability of inexpensive financing. In some instances they are looking for more creative deal structures, such as debt lending and minority positions, in order to deploy capital.

Positive trends in CEO confidence and deal volume



Source: Bloomberg as of September 2014.

Aside from M&A, corporations have sought other ways to put capital to work and deliver value to shareholders, including share buybacks, increased dividends, spin-offs and the pursuit of tax efficient strategies, such as MLP and REIT conversions. Activist managers have been a catalyst for some of these deals, encouraging management to consider more varied approaches to value-creation.

A Shifting Energy Landscape

In recent months, energy pricing has been affected by geopolitical considerations in Eastern Europe and the Middle East. This comes amid a period of longer-term energy industry disruption created by the rapid increase in shale oil and natural gas production in the US. Despite geopolitical volatility, oil prices have failed to sustain a meaningful price increase, though some commodity-focused hedge funds have used this volatility to build or add to short positions, given their bias to be short nearer-dated crude oil.

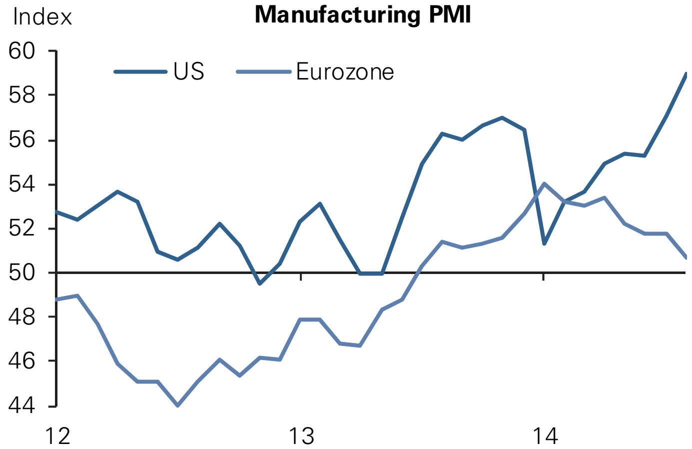
The longer-term disruption to the industry from continued strong US production growth has led to significantly higher volatility in regional energy spreads and time spreads, prompting shifts in pipeline development and new projects. Some managers have suggested that a glut of crude oil could arise in Cushing, Oklahoma (where the WTI crude oil contract is based) in the coming months, thereby creating downward pressure on the front-end of the curve. Other managers remain bullish on longer-dated contracts, suggesting that US production growth is partially offset by declining production elsewhere in the world, and collectively this will be insufficient to offset continued demand growth from emerging markets.

In equity markets, the impact of this secular disruption has varied widely, creating opportunities for some sectors while presenting challenges for others. For instance, some equity long/short managers have noted that US companies that take natural gas or crude oil as an input cost—including refiners and petrochemicals—currently have a significant competitive advantage relative to global peers, which they believe is not yet fully priced into markets.

In the private equity space, managers continue to evaluate the infrastructure development required to transport growing domestic US energy resources, while also focusing on potential longer-term changes in US energy policy. The status of the Keystone XL pipeline and debate around eventually lifting the current ban on crude oil exports have led some private equity managers to invest in export infrastructure. However, there are also important regional differentials within the US, with some private equity managers attracted to investing in "stranded" resource areas, where oil and gas are abundant but extraction and transport infrastructure is lacking.

Notes: Implications of Economic and Policy Divergence

- The US economic expansion has strengthened in recent months while the Eurozone economy has decelerated further. As a result, the synchronized recovery in 2013 has morphed into a divergent recovery, and diverging policy is gaining momentum as an investment theme.

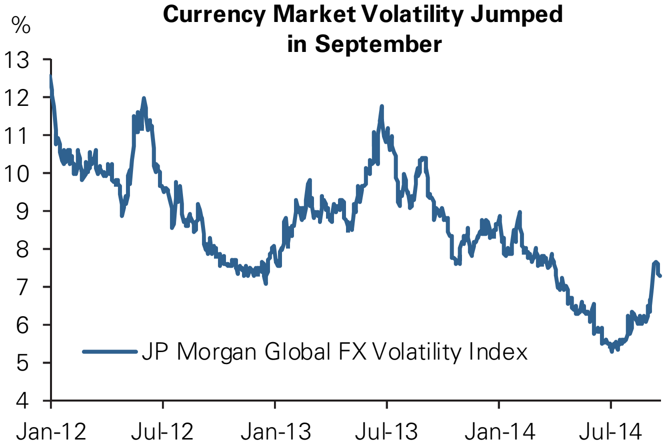


Source: Bloomberg. ISM, Markit

- Our overall takeaways from the September Fed and ECB policy meetings are that 1) the Fed remains on track to begin raising rates at the June 2015 meeting; and 2) the ECB is on a path to full quantitative easing, including purchases of government bonds, in 2015.

- We think the implications of diverging growth and policy are significantly different from those of a synchronized recovery (see table below).

- Currency divergence could be more pronounced than the divergence in US and European government bond yields. ECB easing and Fed tightening could have an offsetting effect that limits the divergence in government yields, but both support a stronger dollar.



Source: Bloomberg, JP Morgan

- Even if US and European government bonds exert some gravitational pull on each other, the direction of rates appears to be influenced by which central bank is moving more aggressively. In 2013, a hawkish shift by the Fed sent global bond yields higher, while in 2014 a dovish move by the ECB sent US longer-term yields lower. In 2015, we expect the change in Fed policy from accommodation to tightening will be more significant, driving US rates higher.

Implications of a Divergent vs Synchronized Economic Recovery

	Synchronized Recovery	**Divergent Recovery**
Monetary Policy	Central banks tighten policy at the same time	Some tighten, some remain accommodative or ease further
Demand	External and domestic demand weaken when central banks want it to	Tightening may slow domestic demand but external demand may not
Interest Rate Change	Smaller, as synchronized tightening limits the need for rate hikes by individual central banks	Larger, as individual central banks moving in opposite directions may need to be more aggressive to achieve domestic objectives
Interest Rate Divergence	Lower, as synchronized tightening limits the amount that one central bank may need to tighten relative to others	Higher, as policy drives rates in opposite directions, but mitigated by continued accommodation in some economies
Capital Flows	Lower, as synchronized recovery brings less divergence in growth and yields	Higher, as capital moves into economies with stronger growth and higher yields
Currency Divergence	Lower due to reduced capital flows and reduced divergence in rates and growth	Much higher as diverging policies both support the currency of the country with tighter policy
Global Macro Volatility	Higher as strong global growth would increase risk of inflation and increase the risk of a global rate shock	Lower as divergent recoveries reduce the potential volatility of global GDP and reduce the potential for global inflationary pressure
Market Volatility	Higher as central banks no longer actively suppress volatility	Higher as central bank divergence increases uncertainty

Source: GSAM. As of September 2014.

Appendix: GSAM Growth Forecasts and Asset Valuation

GDP Growth Forecasts: GSAM vs Consensus

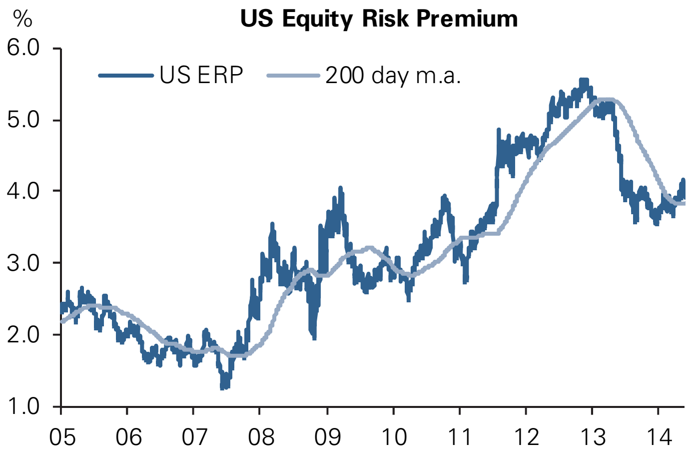
	2011	2012	2013	2014		2015	
				GSAM	Consensus*	GSAM	Consensus*
US	1.8	2.8	1.9	2.2	2.1	3.6	3.0
UK	1.1	0.3	1.7	3.1	3.1	2.8	2.6
Euro area	1.5	-0.7	-0.4	0.8	0.8	1.1	1.4
Japan	-0.6	1.4	1.7	1.4	1.1	1.3	1.2
Brazil	2.7	1.0	2.3	0.5	0.3	1.6	1.4
China	9.3	7.7	7.7	7.3	7.4	7.0	7.2
India	6.3	3.2	4.4	4.9	5.5	5.5	5.4
Russia	4.3	3.4	1.5	0.3	0.3	1.0	1.0
Mexico	4.0	3.7	1.2	2.7	2.5	3.8	3.8
Korea	3.7	2.0	2.8	3.7	3.6	4.0	3.8
Indonesia	6.5	6.2	5.3	5.0	5.2	6.0	5.6
Turkey	8.8	2.2	3.8	3.0	3.1	4.0	3.6
Advanced	1.4	1.3	1.1	1.7	1.6	2.4	2.2
BRIC	7.3	5.5	5.8	5.4	5.5	5.5	5.6
Growth Markets	6.9	5.1	5.2	5.0	5.1	5.3	5.3
World	3.8	3.0	3.0	3.2	3.2	3.8	3.6

*As of September 2014. Source: GSAM and Bloomberg

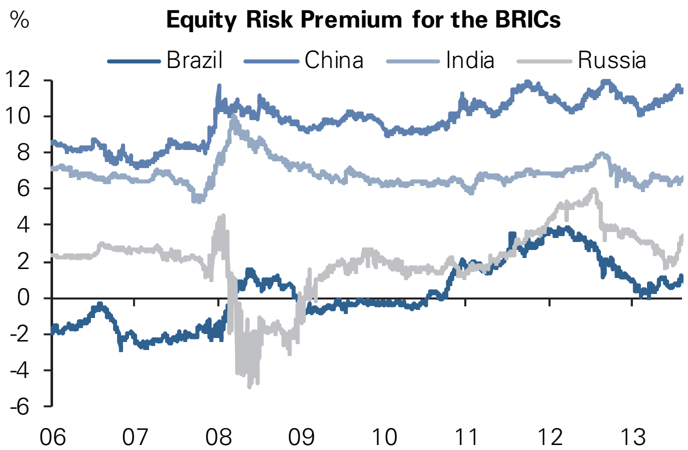
Equity Valuation Across Advanced and Growth Markets

	CAPE*		FY1 PE		Price/Book		Dividend Yield		Earnings Momentum**
	Level	% time cheaper***	Level	% time cheaper***	Level	% time cheaper***	Level	% time cheaper***	% change in 1y fwd EPS
Japan	31.0	47%	13.7	12%	1.3	14%	1.9	30%	0.3
US	22.3	71%	16.0	72%	2.8	70%	1.9	74%	0.0
Canada	20.8	63%	15.2	66%	2.2	81%	2.7	61%	1.7
India	19.1	52%	16.4	79%	3.0	54%	1.4	59%	0.3
Australia	19.1	72%	14.9	72%	2.1	76%	4.4	32%	-2.2
Europe	17.3	55%	14.3	64%	1.8	59%	3.1	60%	-1.8
Germany	16.0	56%	12.5	33%	1.7	51%	2.8	68%	-2.4
France	16.0	49%	13.7	56%	1.5	48%	3.2	64%	-2.4
Italy	14.3	35%	13.2	41%	1.0	31%	2.9	49%	-2.4
UK	14.1	53%	13.6	63%	2.0	61%	3.5	70%	-1.8
Spain	13.0	35%	14.9	79%	1.5	63%	4.9	37%	0.5
China	12.5	28%	9.3	22%	1.5	34%	3.2	22%	0.0
Portugal	11.1	24%	17.6	86%	1.7	47%	3.1	60%	-3.0
Brazil	10.0	30%	11.6	92%	1.6	65%	4.2	33%	-5.0
Russia	5.1	3%	4.5	11%	0.7	8%	4.6	1%	0.1

* Cyclically-adjusted PE ratio (5-yr rolling window). ** % change in 1-yr fwd EPS over last 3 months. *** Current percentile relative to full history
As of September 2014. All data based on MSCI country indices. Source: Datastream, GSAM calculations



Source: GSAM calculations



Source: GSAM calculations

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